State Compensation Insurance Fund

Annual Report 2002

A MESSAGE FROM THE PRESIDENT

Dianne C. Oki, PRESIDENT

During 2002, State Fund fulfilled its legislatively mandated mission to provide California employers an available market for workers' compensation protection. Had we not met this obligation, the problems experienced by California employers in finding coverage would have been significantly exacerbated. By year's end, we insured over 265,000 policyholders. This growth was the result of our competitors continuing systematic withdrawal from the California marketplace. Such a dramatic increase resulted in significant operational and financial strains, but State Fund's commitment to stay the course enabled thousands of California employers and brokers to secure coverage. The bottom line is that our ability to provide such coverage assured the viability of our state's workers' compensation system.

Financial Results

Disagreement with Auditors

In 2002, State Fund's earned premium grew to $5.4 billion from $3.6 billion, representing a 49% increase over our 2001 earned premium and more than doubling our 2000 earned premium. Investment earnings for the year were $573 million and total revenues reached $6.3 billion. Cash and invested assets totaled over $11.0 billion. These invested assets are comprised primarily of high-grade fixed income securities. Our surplus (before audit adjustment) of $1.4 billion is less than we believe is prudently needed to support our current volume of business. Therefore, increasing surplus is a high priority for 2003 and 2004. We believe our reserves for claims payments, at $8.8 billion, are adequate to meet our obligations. Our Appointed Actuary, Milliman USA agrees with us, but PricewaterhouseCoopers ("PwC"), our auditors, believe our reserves should be increased by 11% to $9.8 billion as more fully discussed in their accountant's report included in the following pages. Their recommended increase in reserves would decrease surplus by the same dollar amount to $440 million. We are currently conducting a comprehensive actuarial review of our reserving methods and processes to provide additional guidance as we set reserves for year-end 2003. In addition, the recently enacted workers' compensation reform legislation will have a positive impact on our reserves.

A MESSAGE FROM THE PRESIDENT
CONTINUED

We take the establishment of adequate reserves seriously. If reserves are too low, then policyholders' surplus is impaired by the shortfall. We must set reserves to protect the financial interests of both our policyholders and the State Fund, but we cannot overreact so as to unnecessarily cripple the ability of State Fund when it's most needed to fulfill its mission.

Workers' Compensation Reform

We expect the workers' compensation reform legislation adopted in 2003 to be a significant step toward decreasing system costs which, in turn, will help to make this insurance more available and affordable. We will continue to support all efforts to achieve further necessary reforms in order to bring rate relief to employers and to make the delivery of benefits to injured workers as effective and efficient as possible.

In closing, I would like to assure you that our employees have worked extremely hard to ensure State Fund's role as the stabilizing force within the industry. I want to take this opportunity to thank our employees and many of you for your kind words and support during 2002. I pledge that the people of State Fund will continue to do what's right for California.

Dianne C. Oki

Dianne C. Oki, PRESIDENT

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For several decades, State Fund has produced hard copy editions of our annual report. This year we have joined an increasing number of organizations by presenting our annual financial statement exclusively on our web site. This permits us to present this information at considerable cost savings.

FINANCIAL HIGHLIGHTS

December 31, 2002 and 2001—Dollar amounts in thousands

	2002	2001	Percent change
Assets	11,623,496	9,547,188	21.75
Premiums Earned	5,359,292	3,595,208	49.07
Net Investment Income	572,688	756,690	(24.32)
Compensation & Medical Benefits	4,735,229	3,049,004	55.30
Claim Expenses	538,319	464,043	16.01
Net Income	25,958	170,756	(84.80)
Policyholders' Surplus			
Unassigned Surplus	1,449,361	1,431,381	1.26
Policyholders' Dividends Paid	95,065	99,387	(4.35)
Premium Earned to Policyholders' Surplus Ratio	3.6976930	2.5117058	

The accompanying notes are an integral part of these statutory basis financial statements.

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of
State Compensation Insurance Fund of California

We have audited the accompanying statutory statements of admitted assets, liabilities and policyholders' surplus of State Compensation Insurance Fund of California (State Fund) as of December 31, 2002 and 2001, and the related statutory statements of operations and changes in policyholders' surplus, and of cash flows for the years then ended. These financial statements are the responsibility of State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1, to the financial statements, State Fund prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of California (CDI), which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between such practices and generally accepted accounting principles are material; they are described in Notes 1 and 8.

In our opinion, because of the effects of the matters referred to in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of State Compensation Insurance Fund of California at December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended.

As discussed in Note 1 to the financial statements, State Fund records estimated liabilities for the future cost of known outstanding claims, the cost of claims incurred but not reported, and expenses related to investigating and settling claims. State Fund has recorded reserves of $9.8 billion for these liabilities at December 31, 2002. Accounting principles prescribed or permitted by the CDI require that State Fund record sufficient reserves to meet these liabilities. We believe that these reserves should be increased by approximately $1 billion. See Note 1 regarding the variability of this estimate. This assessment was corroborated by a Draft Limited Scope Examination Report issued by the CDI on July 2, 2003 in which the CDI concluded that reserves were determined to be deficient by $1 billion.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly the admitted assets, liabilities and surplus of State Compensation Insurance Fund of California at December 31, 2002 and the results of its operations and its cash flows for the year then ended on the basis of accounting described in Note 1.

REPORT OF INDEPENDENT AUDITORS, CONTINUED

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and surplus of State Compensation Insurance Fund of California at December 31, 2001, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note 1.

The accompanying financial statements have been prepared assuming State Fund will continue as a going concern. As discussed in Note 2 to the financial statements, the CDI imposes Risk-Based Capital (RBC) requirements on insurance companies. At December 31, 2002 State Fund's total capital, as reported in the accompanying financial statements, compared to RBC required amounts causes a regulatory action level event. The impacts of this shortfall in capital and management's plan with regard to this matter are described further in Note 2 to the financial statements. Management has determined that State Fund has the ability to continue to meet its obligations as they become due for one year beyond the balance sheet date without substantial disposition of assets outside the ordinary course of business, based on either recorded reserves, or reserves adjusted as discussed above. The CDI's Draft Limited Scope Examination Report described above concludes that RBC adjusted to reflect the $1 billion increase in reserves places State Fund within the mandatory control level of RBC. When a mandatory control level event occurs the commissioner is generally required to take the actions that are necessary to cause a company to be placed under regulatory control, which could result in forced revisions of its operations. The applicability of RBC to the State Fund is subject to a legal determination described in Note 2. The possibility of regulatory control raises substantial doubt about State Compensation Insurance Fund's ability to continue as a going concern. The financial statements do not include adjustments, if any, that might result from the outcome of this uncertainty.

As discussed in Note 1, during the year ended December 31, 2002, State Fund changed its method of accounting for unearned and earned but unbilled premiums and for costs of computer software developed or obtained for internal use.

As discussed in Note 1 to the financial statements, effective January 1, 2001 State Fund adopted the accounting policies in the *Revised National Association of Insurance Commissioners Accounting Practices and Procedures Manual*—effective January 1, 2001, as required by the CDI. The effect of adoption is recorded as an adjustment to policyholders' surplus as of January 1, 2001.

PricewaterhouseCoopers LLP

July 17, 2003

STATEMENTS OF ADMITTED ASSETS, LIABILITIES AND POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

December 31, 2002 and 2001—Dollar amounts in thousands

	2002	2001
Admitted assets		
Bonds, at amortized cost	$ 8,881,422	$7,898,661
Money market fund	837,716	505,473
Cash (on hand and on deposit)	411,658	127,479
Total cash and investments	10,130,796	8,531,613
Collateral for loaned securities	698,721	434,312
Property and data processing equipment, at cost less accumulated depreciation	209,611	189,938
Premiums in the course of collection, outstanding less than 90 days (including earned but unbilled premium of $204,471 and $104,808 at December 31, 2002 and 2001, respectively)	304,913	170,338
Bills receivable taken for premiums	289	1,551
Reinsurance receivable	3,036	1,189
Accrued interest and dividends	119,426	121,713
Other assets	156,704	96,534
Total admitted assets	$11,623,496	$9,547,188
Liabilities and policyholders' surplus		
Estimated liabilities for:		
Compensation and medical benefits	$ 8,997,265	$6,447,464
Claim expenses	840,702	719,858
Retroactive reinsurance ceded	(1,035,000)	—
Collateral for loaned securities	698,471	434,630
Unearned premiums	235,754	260,158
Reinsurance payable	37,363	13,732
Dividends declared and unpaid	12,800	15,800
Other liabilities	386,780	224,165
Total liabilities	10,174,135	8,115,807
Unassigned surplus	1,129,605	1,431,381
Special surplus for retroactive reinsurance	319,756	—
Policyholders' surplus	1,449,361	1,431,381
Total liabilities and policyholders' surplus	$11,623,496	$9,547,188

The accompanying notes are an integral part of these statutory basis financial statements.

STATEMENTS OF OPERATIONS AND CHANGES IN UNASSIGNED POLICYHOLDERS' SURPLUS (STATUTORY BASIS)

December 31, 2002 and 2001—Dollar amounts in thousands

	2002	2001
Net premiums written	$5,349,914	$3,614,107
Change in unearned premiums	(59,636)	(92,010)
Change in earned but unbilled premiums	69,014	73,111
Net premiums earned	5,359,292	3,595,208
Compensation and medical benefits incurred	4,735,229	3,049,004
Claim expenses incurred	538,319	464,043
Underwriting and administrative expenses	804,742	566,856
Taxes and fees	147,488	101,239
Total underwriting deductions	6,225,778	4,181,142
Net underwriting loss	(866,486)	(585,934)
Investment income	607,053	800,644
Investment expenses	(34,365)	(43,954)
Net investment income	572,688	756,690
Other income:		
Retroactive reinsurance gain	319,756	—
Net income, before policyholders' dividends	25,958	170,756
Dividends paid to policyholders	(95,065)	(99,387)
Decrease in dividends declared and unpaid	3,000	13,200
Net income (loss)	(66,107)	84,569
Unassigned policyholders' surplus, beginning of year	1,431,381	1,350,333
Cumulative effect of changes in accounting principles	134,672	18,000
Change in nonadmitted assets	(61,334)	(11,890)
Change in unrealized gains and losses	10,749	(9,675)
Change in provision for reinsurance	—	44
Unassigned policyholders' surplus, end of year	$1,449,361	$1,431,381

The accompanying notes are an integral part of these statutory basis financial statements.

STATEMENTS OF CASH FLOWS (STATUTORY BASIS)

December 31, 2002 and 2001—Dollar amounts in thousands

	2002	2001
Premiums collected net of reinsurance	$ 5,305,761	$ 3,596,941
Loss and loss adjustment expenses paid, net of salvage and subrogation received	(2,604,750)	(1,791,252)
Underwriting expenses paid	(900,861)	(582,291)
Other underwriting income (expense)	2,449	(29)
Cash provided by underwriting	1,802,599	1,223,369
Investment income, net of investment expenses	553,041	501,870
Other income (loss)	338,096	(6,353)
Dividends to policyholders	(95,065)	(99,387)
Net cash provided by operations	2,598,671	1,619,499
Proceeds from investments sold, matured or repaid		
Bonds	2,487,498	2,803,194
Money market fund	4,075,351	4,189,087
Collateral for loaned securities	263,850	434,312
Real estate	4,404	92
Total investment proceeds	6,831,103	7,426,685
Total cash provided	9,429,774	9,046,184
Cost of investments acquired		
Bonds	3,434,073	3,988,696
Money market fund	4,407,594	4,484,897
Real estate	1,688	952
Other	1,037,831	104,780
Total cash applied	8,881,186	8,579,325
Net change in cash and short-term investments	548,588	466,859
Cash and cash collateral for loaned securities, beginning of year	561,791	94,932
Cash and cash collateral for loaned securities, end of year	$ 1,110,379	$ 561,791

The accompanying notes are an integral part of these statutory basis financial statements.

NOTES TO FINANCIAL STATEMENTS

December 31, 2002 and 2001—Dollar amounts in thousands

1. Summary of Significant Accounting Policies

History and business

State Compensation Insurance Fund (State Fund) is an agency of the State of California established by legislation enacted in 1913 to provide workers' compensation insurance coverage to employers located in California. State Fund is vulnerable to catastrophes, such as earthquakes, which have not had a significant adverse effect on operations in the past but represent risks in the future.

Basis of presentation

The financial statements of State Fund are prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of California (CDI).

Changes in accounting policies, codification of statutory accounting principles

The State Compensation Insurance Fund prepared its Statutory Financial Statements in conformity with accounting practices prescribed or permitted by the State of California. Effective January 1, 2001, the State of California required that insurance companies domiciled in the State of California prepare their Statutory basis Financial Statements in accordance with the NAIC Accounting Practices and Procedures Manual (effective January 1, 2001) subject to any deviations prescribed or permitted by the Insurance Commissioner of the State of California.

Accounting changes adopted to conform to the "codified" provisions of the NAIC Accounting Practices and Procedures Manual - Version effective January 1, 2001 were reported as changes in accounting principles. The cumulative effect of changes in accounting principles is reported as an adjustment to unassigned funds (Surplus) in the period of the change in accounting principles.

Significant changes upon adoption of codification on January 1, 2001 were:

- Purchases and sales of bonds are recorded on trade date basis as opposed to settlement date basis.
- Purchases of nonadmitted fixed assets are capitalized and subject to depreciation and the net book value charged to surplus. Previously these items were expensed as acquired.
- Service fees relating to claims administration services provided to non-policyholders which are outstanding over ninety days are prospectively reported as a nonadmitted asset and as an adjustment to surplus.
- Earned but unbilled premiums are recorded as an adjustment to earned premium.
- A liability is accrued for estimated future assessments under the Longshore and Harbor Workers' (U.S. L&H) Compensation Act.

As a result of the accounting changes in 2001 State Fund recorded, as a cumulative effect adjustment, an increase to surplus of $18,000 comprised of:

Earned but unbilled premium	$ 31,000
U.S. L&H assessment	(13,000)
Cumulative effect adjustment	$ 18,000

In 2002, State Fund changed its method for calculating Unearned Premium and Earned But Unbilled Premiums. Previously, State Fund calculated unearned premiums using a semimonthly method by assuming that on average policies incepted mid-way through a month. Therefore, that portion of the deposit premium that represented one half month's premium was considered unearned. Earned but unbilled premiums were calculated using an actuarially determined estimate based on historical earned premium data. In 2002, State Fund changed its method whereby daily-earned premium is calculated for each individual policy. The earned premium for each policy is compared to the total premium received and outstanding, both deposit and installment, and the difference is recorded as unearned premium or earned but unbilled premium.

December 31, 2002 and 2001—Dollar amounts in thousands

As a result of the accounting changes in 2002 State Fund recorded, as cumulative effect adjustment, an increase to surplus of $134,672 comprised of:

Unearned premium	$ 83,839
Earned but unbilled premium	47,832
Other	3,001
	$134,672

The impact on net income had these changes been adopted in 2001 is not readily determinable.

The principal statutory accounting practices followed by State Fund which differ from generally accepted accounting principles (GAAP), as prescribed by the Governmental Accounting Standards Board, applicable to its operations are:

- Investment securities are principally carried at amortized cost whereas under GAAP such securities would be carried at estimated market value with changes in market value reflected in net income.
- Policy acquisition costs, including premium taxes, are charged to current operations as incurred, whereas related premium income is recognized on a pro rata basis over the periods covered by the policies. Under GAAP policy acquisition costs would be deferred and amortized to income on the same basis as premium income is recognized.
- Certain assets designated as “nonadmitted assets” are excluded from total assets. These assets consist principally of premiums in the course of collection outstanding over ninety days, ten percent of EBUB in excess of collateral specifically held and identifiable, office furniture and equipment and prepaid expenses, the change in which is credited or charged directly to policyholders’ surplus. Under GAAP these assets would be included in total assets.
- Assets and liabilities are presented net of certain effects of reinsurance, instead of being presented gross in accordance with GAAP.
- The gain upon entering into a retroactive reinsurance contract is recognized in income and established as segregated surplus. GAAP requires the gain to be deferred and recognized over the estimated settlement period of the reinsured losses using either a recovery or interest method.
- Policyholders’ dividends are accrued when declared whereas under GAAP they are accrued currently using estimates of amounts to be paid.
- Fees received for processing the claims of other self-insured State of California departments are presented net of the costs incurred to process these claims, instead of being presented gross in accordance with GAAP.
- Self rent is excluded from income and expense under GAAP.
- The statement of cash flows differs in certain respects from the presentation required by GAAP. Cash and short-term investments in the statement of cash flows includes collateral for loaned securities.
- In 2001, the cumulative effect of a change in accounting principle is recorded as an adjustment to surplus rather than as a component of net income as generally required by GAAP. In 2002, Governmental Accounting Standard No. 34 requires that a change in accounting principle be recorded as an adjustment to opening surplus in the year of change.

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

The aggregate effects of these differences on certain financial statement components are set forth in Note 8.

Use of estimates in preparation of financial statements
The preparation of financial statements in conformity with statutory accounting principles permitted or prescribed by the CDI requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although management records its best estimate of its liability for claims and settlement expenses, actual results could differ materially from those estimates.

Management's estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate amounts, particularly loss and loss adjustment expense reserves, at the date of the financial statements. Management's judgment is based on its knowledge and experience about past and current events and circumstances and its assumptions about conditions it expects to exist in the future. Factors relevant to the estimation of loss and loss adjustment expense liabilities include the estimation of the ultimate frequency and severity of losses, the level of future medical cost inflation over long periods of time, the future legal environment, and the amount of future expenses required to investigate and settle claims. Management's estimates are reviewed quarterly by a nationally-recognized qualified consulting actuarial firm (the "Appointed Actuary"). The Appointed Actuary is retained in accordance with CDI regulatory provisions as the designee to issue a statement of actuarial opinion that has been reviewed with the Board of Directors as required by actuarial standards of practice.

Investments
Investments are valued in accordance with the requirements of the Securities Valuation Office of the National Association of Insurance Commissioners (the "NAIC"). Short-term investments and investments in money market funds are carried at cost, which approximates market. Bonds are principally carried at amortized cost using the scientific (constant yield) interest method. Loan backed bonds are valued using the retrospective adjustment method.

The aggregate market value of fixed income securities is determined from independent quotations obtained from the NAIC and independent pricing sources. Realized gains or losses on sale or maturity of investments are determined on the basis of specific identification and are included in net income.

Declines in fair value of investments that are deemed to be other than temporary, are included in investment income as a realized loss. Subsequent recoveries in value are reflected as increases in unrealized gains and included as a component of policyholders' surplus.

Cash
Cash consists of cash in banks and on hand.

Property and depreciation
Depreciation on buildings is computed on a straight-line basis over the estimated useful lives of the buildings (40 to 50 years). Data processing equipment owned by State Fund is carried at cost less accumulated depreciation computed on a straight-line basis over the estimated useful lives of the equipment (3 years). Depreciation on office furniture and equipment is computed on a straight-line basis over the estimated useful lives of the assets (3 to 5 years).

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

In 2001, costs related to internal use software were expensed as incurred. Beginning in 2002, these costs are capitalized and are depreciated over three years.

Estimated liabilities for compensation and medical benefits and claim expenses
Management books its best estimate of liability for compensation and medical benefits and claims expenses. These liabilities include the estimated future cost of reported claims, the cost of claims incurred but not reported, and expenses related to investigating and settling claims. State Fund does not discount estimated liabilities for compensation and medical benefits and claim expenses. These liabilities are necessarily based on estimates and the ultimate liabilities may vary materially from such estimates. Any adjustments to these estimates are reflected in income when known.

During 2002 and 2001, State Fund experienced significant growth in its volume of business. State Fund has limited ability to restrict growth as a result of its mission and the legislation enacted to create State Fund. The growth in new business increases the variability normally inherent in estimating liabilities for compensation and medical benefits.

Subsequent to filing its year end annual statement with the CDI, State Fund received a Draft Limited Scope Examination Report of the State Fund as of December 31, 2002. The CDI believes that State Fund's loss reserves are understated by approximately $1 billion. In addition, the Independent Auditor for the State Fund, PricewaterhouseCoopers LLP ("PwC") believes that loss reserves need to be increased by approximately $1 billion at December 31, 2002 for the financial statement to be fairly presented in accordance with Statutory Accounting Principles.

The higher estimates determined by PwC and the CDI relied on a balance of several additional actuarial methods including an incurred loss development methodology. State Fund has consistently relied on paid loss development and Milliman USA methodologies to estimate loss and loss expense reserves. Management believes that paid loss methods provide a more appropriate basis than other methods to project future development. Paid loss development is not affected by changes in case reserve adequacy. Changes in the frequency of cumulative injury claims and benefit levels do not affect the method to the same extent as the incurred loss development method. At the same time the paid loss method is slower to respond when there is a slowdown in payment or settlement patterns.

Management continues to monitor claim frequency and severity trends, the development of previous loss and loss expense reserve estimates, and other relevant factors to evaluate the propriety of actuarial methodologies and estimates used by State Fund. State Fund's Appointed Actuary reviews quarterly the propriety of the actuarial methodologies used by management. If, in management's opinion, a change in actuarial methodology is required to produce a more reasonable estimate of loss and loss expense reserves, the effect of any such change in methodology will be reflected in income during the period in which that change is adopted.

Because the ultimate payout of claims is subject to future contingent events, no estimate of loss and loss adjustment expense reserves can be considered accurate with certainty.

As described further in Note 2, State Fund has a low level of surplus relative to premium and reserves. A small adverse adjustment to reserves, which could otherwise be deemed insignificant, can have a significant impact on surplus, and compliance with capital and Risk-Based Capital (RBC) requirements.

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

Revenue recognition and unearned premiums

State Fund records as premiums written deposit premium and any subsequent additional premiums at the time related billings are issued to policyholders. Deposit premiums are a percentage of estimated annual premiums and are earned pro rata over the policy term. Unearned premiums are the unexpired portion of deposit premiums. State Fund records an estimate for earned but unbilled premiums as a direct adjustment to earned premiums. In 2000, prior to the adoption of codification, State Fund did not record earned but unbilled premiums as revenue. State Fund considers anticipated investment income when determining the existence of a premium deficiency.

Surcharges

Under the California Insurance Code, all casualty insurance carriers including State Fund are required to participate in the California Insurance Guarantee Association (C.I.G.A.) and the Workers' Compensation Administration Revolving Fund (W.C.A.). C.I.G.A. was established to protect the claimants of insolvent insurance companies. W.C.A. was established to partially fund administration of the workers' compensation system. In 1992, an additional Workers' Compensation Fraud Assessment (Fraud Assessment) was instituted by the State of California to provide funding for investigation and prosecution of workers' compensation fraud. Assessments are determined based on premiums written as defined by the applicable insurance code section. All casualty insurance companies, including State Fund, are required by law to bill their policyholders a premium surcharge for recoupment of C.I.G.A., W.C.A. and Fraud Assessments. Upon payment of an assessment State Fund establishes a receivable, included in other assets, for the related collections of surcharges from policyholders. Amounts collected in excess of the assessment result in a payable to the assessor which is included in other liabilities. Payments of assessments and related collections of surcharges from policyholders have no effect on the operations of State Fund.

Under the U.S. Workers' L&H Compensation Act, all carriers and self insurers writing U.S. L&H policies, including State Fund, are required to make payments into a Special Fund based on a prorated assessment determined by the Secretary of Labor. The Special Fund was created to protect injured employees or their survivors by providing for subsequent injuries as defined by the Act. State Fund accrues a liability for future assessments under the U.S. L&H Workers' Compensation Act.

Policyholders' surplus and dividends

The Board of Directors of State Fund (the Board) declares dividends payable to policyholders when available surplus exceeds levels of surplus required for operations and contingencies. Unassigned surplus at December 31, 2002 is available for declaration and payment of dividends to eligible policyholders. Due to the surplus requirements to support State Fund's recent growth, policyholder dividends have been suspended until available surplus exceeds minimum capital requirements.

Retirement and post-retirement benefit plans

All State Fund employees participate with other State of California (the State) employees in the State pension and other post-retirement (medical and dental) benefit plans administered by the Public Employees' Retirement System of the State of California (CALPERS). CALPERS assesses pension expense to participating state agencies based on relative salaries paid to state agency employees to the total salaries paid to all state employees and assesses other post-retirement benefit expense based on relative number of state agency employees to all state employees. State Fund was assessed pension expense of $17,373 in 2002 and $5,250 in 2001 and assessed other post-retirement benefits expense of $12,476 in 2002 and $10,280 in 2001.

Income taxes

State Fund is exempt from income taxation under the Internal Revenue Code.

2. Risk-Based Capital Impact on State Fund's Ability to Continue As a Going Concern

The company's financial statements have been prepared assuming the State Fund will continue as a going concern. Management has determined that State Fund has the ability to continue to meet its obligations as they become due for one year beyond the balance sheet date without substantial disposition of assets outside the ordinary courses of business, based on either recorded reserves or after recognition of $1,000,000 in additional loss and loss adjustment expense reserves at December 31, 2002 as discussed in Note 1. California law imposes RBC requirements on admitted California workers' compensation companies. These RBC requirements set target levels of surplus and provide specific remedies for failure to meet these target requirements. The Department of Insurance has asserted that these RBC standards apply to the State Fund. Since the State Fund is a creation of the State Constitution and Legislature, rather than a licensee of the Department of Insurance, the State Fund does not believe the Commissioner has any authority to control the operations of the State Fund. The State Fund has applied to the courts for a formal legal determination of the issue.

If the RBC requirements were determined to be applicable, the State Fund would be at a Regulatory Action Level Event in accordance with these financial statements as presented by management. With recognition of an additional $1,000,000 in loss and loss adjustment expense reserves at December 31, 2002 as discussed in Note 1, State Fund would be at a Mandatory Control Level Event.

Surplus targets such as RBC must be viewed in light of the Constitutional and statutory requirement that State Fund be an available market for California employers. Given the substantial number of carrier insolvencies in the California market in 2000 and 2001, a significant number of employers came to the State Fund for coverage. This large influx of business significantly increased State Fund's premium volume and related capital requirement. The State Fund has voluntarily submitted both 2002 and 2003 plans of action to limit its insurance exposure and to improve its capital position. A number of specific steps have been taken in accordance with those plans, including significant rate increases and commission reductions.

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

3. Investment Securities

The amortized cost and estimated market values of investments in fixed income securities at December 31, 2002 are as follows:

	Amoritized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
US Treasury securities and obligations of US governmental corporations and agencies	$2,437,704	$170,688	$ (4)	$2,608,389
Obligations of states and political subdivisions	277,472	17,428	(74)	294,826
Public utilities	727,228	59,013	(1,078)	785,162
Corporate debt securities	2,727,046	237,888	(10,327)	2,954,607
Special revenue	90,088	1,435	—	91,523
Mortgage-backed securities	2,621,884	114,792	(17)	2,736,659
Totals	$8,881,422	$601,244	$(11,500)	$9,471,166

The amortized cost and estimated market values of investments in fixed income at December 31, 2001 are as follows:

	Amoritized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
US Treasury securities and obligations of US governmental corporations and agencies	$1,560,240	$ 25,324	$(16,324)	$1,569,240
Obligations of states and political subdivisions	140,579	1,859	(1,336)	141,102
Public utilities	1,068,692	26,709	(10,813)	1,084,587
Corporate debt securities	2,997,770	60,702	(27,407)	3,031,066
Special revenue	200,821	2,747	(290)	203,278
Mortgage-backed securities	1,930,559	30,547	(14,051)	1,947,055
Totals	$7,898,661	$147,888	$(70,221)	$7,976,328

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

The amortized cost and estimated market values of fixed income securities at December 31, 2002, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
Due in one year or less	$ 138,363	$ 141,224
Due after one year through five years	1,795,201	1,894,597
Due after five years through ten years	3,330,265	3,626,508
Due after ten years	995,709	1,072,178
Mortgage-backed securities	2,621,884	2,736,659
	$8,881,422	$9,471,166

Proceeds from sales of investments in debt securities during 2002 were $2,487,498. Gross gains of $83,258 and gross losses of $44,413 were realized on these sales. Proceeds from sales of investments in debt securities during 2001 were $2,803,194. Gross gains of $241,173 and gross losses of $5,756 were realized on these sales.

Included in the amortized cost of corporate debt securities at December 31, 2002 is an adjustment of $352 to reflect market values which are less than amortized cost for bonds where the NAIC has determined that the decline in value should be recorded.

State Fund's investment policies limit concentration of credit risk by diversifying its investment portfolio. As the portfolio is diversified and issuers of securities are dispersed throughout many industries and geographies, the concentration of credit risk is limited.

At December 31, 2002, State Fund had $3 million on deposit with the Federal Reserve Bank of San Francisco to satisfy U.S. Department of Labor regulations relating to State Fund's issuance of U.S. L&H policies.

The CDI permits State Fund to lend a certain portion of their securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. A third party lending agent has been contracted to lend U.S. Treasury notes and bonds. Collateral, in the form of cash and other securities, is adjusted daily and is required at approximately 102% of the fair value of securities loaned. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The maximum loan term is one year. In accordance with State Fund's investment guidelines, cash collateral is invested in short-term investments with maturities matching the related loans. Interest income on these investments is shared by the borrower, third party lending agent, and State Fund. The aggregate market value of loaned securities was $707,300 and $431,060 at December 31, 2002 and 2001, respectively. Collateral received in respect to these loans consisted of $698,471 in cash and $14,156 in securities as at December 31, 2002 and $434,630 in cash and $3,024 in securities as at December 31, 2001. A liability is recognized for the cash collateral received. A related asset equal to the market value of the reinvested cash collateral is also recognized. The market value of the reinvested cash collateral was $698,721 and $434,312 at December 31, 2002 and 2001, respectively.

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

4. Property and Data Processing Equipment

Property and data processing equipment comprise the following:

	2002	2001
Office buildings	$ 204,296	$ 207,873
Land	26,430	27,806
Data processing equipment and software	105,681	80,779
Office furniture and equipment	4,984	3,815
	341,391	320,273
Accumulated depreciation	(127,667)	(127,004)
	213,724	193,269
Less nonadmitted assets	(4,113)	(3,331)
	$ 209,611	$ 189,938

Depreciation expense was $10,442 in 2002 and $6,260 in 2001. The cost of assets retired or otherwise disposed of, and the related accumulated depreciation thereon, are removed from the accounts with any gain or loss realized upon sale or disposal credited or charged to operations.

5. Commitments and Contingencies

At December 31, 2002, State Fund was committed under the terms of renewable leases for 23 offices and various vehicle and other leases.

The following is a summary of the minimum annual rental commitments:

Year	
2003	43,060
2004	39,279
2005	31,852
2006	23,001
2007	20,406
Thereafter	45,057
	202,655

The district office leases generally require additional rental payments comprising State Fund's pro rata share of increases in real estate taxes and building operating expenses. Rental expense under such leases was $20,255 in 2002 and $17,436 in 2001. Total rental expense charged to operations, which includes an allocation of rental value to space owned and occupied by State Fund, was $41,907 in 2002 and $36,377 in 2001. Vehicle and other lease expenses charged to operations were $23,693 in 2002 and $13,529 in 2001.

Various suits and claims arising in the ordinary course of business are pending against State Fund. State Fund was named as a defendant in a class action lawsuit *A&J Liquors, et al, v. State Fund.* The plaintiffs in this lawsuit contend that State Fund deliberately overstated reserves in the years 1989 to 1994, resulting in substantial premium and dividend damages to its policyholders. In June 2003, the judge found in favor of State Fund. The time for appeal has not been exhausted yet. While management does not believe the case has merit and is contesting

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

it vigorously, the outcome of this matter is not predicable with certainty. However, in the opinion of State Fund's management, the amount of ultimate liability with respect to such matters will not have a material adverse effect on the financial position of State Fund.

6. Reinsurance

State Fund cedes insurance risk relating to its workers' compensation business to several reinsurance companies. Reinsurance agreements are used to limit State Fund's maximum liability on insurance claims and to catastrophes, thereby stabilizing losses and providing greater diversification of risk. In accordance with statutory accounting practices, the reinsured risks are treated as though State Fund is not liable for covered losses; however, State Fund remains liable to the extent reinsuring companies are unable to meet their treaty obligations. During 2002, State Fund maintained per claimant excess of loss coverage of $5 million in excess of State Fund's retention of $5 million and per occurrence catastrophe excess of loss coverage of $990 million in excess of State Fund's retention of $10 million. During 2001, State Fund maintained per claimant excess of loss coverage of $5 million in excess of State Fund's retention of $5 million and per occurrence catastrophe excess of loss coverage of $490 million in excess of State Fund's retention of $10 million. Total earned premiums ceded under reinsurance contracts in 2002 and 2001 were $142,632 and $23,969, respectively. Based upon estimated reinsurance recoverable under reinsurance treaties, State Fund's liabilities for unpaid claims were reduced by $225,296 and $181,864 at December 31, 2002 and 2001, respectively, including $72,192 and $71,700 recoverable from American Reinsurance Company at December 31, 2002 and 2001, respectively. Reinsurance recovered for reimbursement of paid losses was $4,728 and $3,341 in 2002 and 2001, respectively.

In August 2002, State Fund entered into a Loss Portfolio Transfer agreement with XL Re Ltd. and ACE Bermuda Insurance Ltd. (the Reinsurers). State Fund ceded loss reserves of $1,035,000 and paid $726,953, thus recognizing a retroactive gain of $319,756. This gain is reported as a write-in item on the statement of income, identified as Retroactive Reinsurance Gain and included under Other Income. Any subsequent changes in the total reserves ceded under the agreement are reported through an increase or reduction in reserve ceded, with a corresponding gain or loss to other income.

The Special Surplus from Retroactive Reinsurance Account on the balance sheet is adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus arising from the transaction will be considered to be earned surplus and transferred to unassigned funds (surplus) when cash recoveries from the reinsurers exceeds the total consideration paid by the Company for the loss portfolio transfer.

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

7. Estimated Liabilities for Compensation and Medical Benefits and Claim Expenses

Changes in estimated liabilities for compensation and medical benefits and claim expenses are summarized as follows:

	2002	2001
Gross estimated liabilities for compensation and medical benefits and claim expenses as of January 1	$7,349,186	$5,585,828
Less reinsurance recoverable as of January 1	181,864	140,542
Net estimated liabilities for compensation and medical benefits and claim expenses as of January 1	7,167,322	5,445,286
Add		
Net incurred in current year relating to current accident year	4,727,544	3,549,170
Net incurred in current year relating to prior accident years	546,004	(36,123)
Total estimated compensation and medical benefits and claim expenses incurred	5,273,548	3,513,047
Deduct		
Net paid in current year relating to current accident year	703,048	548,479
Net paid in current year relating to prior accident years	1,901,702	1,242,767
Total compensation and medical benefits and claim expenses paid	2,604,750	1,791,246
Increase (decrease) in reinsurance receivable	1,847	235
Net estimated liabilities for compensation and medical benefits and claim expenses as of December 31	9,837,967	7,167,322
Add reinsurance recoverable as of December 31	225,296	181,864
Gross estimated liabilities for compensation and medical benefits and claim expenses as of December 31	$ 10,063,263	$7,349,186

Incurred compensation and medical claim expenses relating to insured events in prior years increased approximately $546 million and decreased approximately $36.1 million in 2002 and 2001, respectively. This was principally due greater than expected medical inflation on recent accident years.

The total amount of loss reserves no longer carried due to the purchase of annuities, with the claimant as payee, was $163,282 at December 31, 2002. State Fund remains liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.

Loss reserves eliminated by annuities issued by the following companies exceeded 1% of Policyholders' Surplus:

Life Insurance Company & Locations	Loss Reserves Eliminated by Annuities
GE Financial Assurance	$ 63,238
Allstate Life Insurance	20,276
CGU Life Insurance Company	33,905
Total	$117,419

NOTES TO FINANCIAL STATEMENTS
CONTINUED

December 31, 2002 and 2001—Dollar amounts in thousands

8. Effects of the Differences Between Statutory Accounting Principles and Generally Accepted Accounting Principles

Under generally accepted accounting principles, total capital and surplus would have increased by $399,374 and net income would have increased by $451,205, as of and for the year ended December 31, 2002 before any adjustment to loss reserves, see Note 1. Total capital and surplus would have decreased by $101,912 and net income would have decreased by $198,437, as of and for the year ended December 31, 2001.

9. Reconciliation to Previously Reported Amounts

The accompanying financial statements reflect an adjustment to amounts previously reported in State Fund's Annual Statement for the year ended December 31, 2001. The adjustment to reconcile the audited financial statements to the Annual Statement filed with the CDI related to a liability for certain settlements that was reflected as a charge to surplus in the Annual Statement. In the audited financial statements this liability was charged to income. This adjustment had no effect on admitted assets, liabilities or policyholders' surplus. The impact of this adjustment was as follows:

	As Reported in the Annual Statement	As Reported in the Accompanying Financial Statements
Policyholders' surplus at December 31, 2000	$1,350,333	$1,350,333
Cumulative effect of changes in accounting principles	18,000	18,000
Change in nonadmitted assets	(11,890)	(11,890)
Change in unrealized gains and losses	(9,675)	(9,675)
Change in provision for reinsurance	44	44
Special liability fund	(25,900)	—
Net income	110,469	84,569
Policyholders' surplus at December 31, 2001	$1,431,381	$1,431,381

REPORT OF INDEPENDENT AUDITORS ON SUPPLEMENTAL INFORMATION

To the Board of Directors of
State Compensation Insurance Fund

The report on our audit of the basic statutory basis financial statements (the "financial statements") of State Compensation Insurance Fund (State Fund) as of December 31, 2002 and for the year then ended is presented in the first section, on pages 1 and 2 of this document. That audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying Supplemental Summary Investment Schedules and Investment Risk Interrogatories of State Fund as of December 31, 2002 and for the year then ended are presented for purposes of additional analysis and are not a required part of the financial statements. The effects on the Supplemental Summary Investment Schedules and Investment Risk Interrogatories of the variances between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not determined, are presumed to be material. As a consequence, the Supplemental Summary Investment Schedules and Investment Risk Interrogatories do not present fairly, in conformity with accounting principles generally accepted in the United States of America, such information of State Fund as of December 31, 2002 and for the year then ended. The Supplemental Summary Investment Schedules and Investment Risk Interrogatories have been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, are fairly stated in all material respects in relation to the financial statements taken as a whole.

PricewaterhouseCoopers LLP

July 17, 2003

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES

December 31, 2002–Dollar amounts in thousands

The following is a summary of certain financial data included in other exhibits and schedules subjected to audit procedures by independent auditors of State Fund's 2002 Statutory Annual Financial Statement as filed with state regulatory authorities. The following information is as of December 31, 2002.

State Fund's total admitted assets as filed in the 2002 Annual Statement is $11,623,496.

State Fund's ten largest exposures to a single issuer/borrower/investment, excluding U.S. government, U.S. government agency securities and those U.S. government money market funds are as follows:

Investment	Investment Category	Amount	Percentage of Total Admitted Assets
SBC Communication	Public Utilities and Industrial	$118,794	1.0%
Ontario	State, Territories and Possessions	112,849	1.0
Morgan, JP	Industrial	95,195	0.8
Verizon	Public Utilities and Industrial	91,205	0.8
Merrill Lynch	Industrial	89,495	0.8
Alcoa	Industrial	87,002	0.7
CITI	Industrial	84,862	0.7
Lehman	Industrial	80,676	0.7
Ford	Industrial	78,678	0.7
Wells Fargo	Industrial	76,613	0.7

The amounts and percentages of State Fund's total admitted assets held in bonds by NAIC rating is as follows:

Rating	Amount	Percentage of Total Admitted Assets
NAIC — 1	$8,665,058	74.5%
NAIC — 2	210,697	1.8
NAIC — 3	5,668	0.0

State Fund does not have any preferred stocks.

State Fund does not hold any foreign investments other than Canadian investments.

State Fund's equity interests are as follows:

Investment	Amount	Percentage of Total Admitted Assets
Blackrock Institutional Funds — Money Market Fund	$837,716	$7.2%

SUPPLEMENTAL SUMMARY INVESTMENT SCHEDULES AND INVESTMENT RISK INTERROGATORIES, CONTINUED

December 31, 2002–Dollar amounts in thousands

State Fund had following amounts subject to securities lending agreements.

At Year End		At End of Each Quarter		
	% of Total Admitted Assets	1st Quarter	2nd Quarter	3rd Quarter
$619,600	5.3%	$614,095	$619,050	$621,520

	Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement
Bonds:		
U.S. treasury securities	$ 821,335	$ 821,335
U.S. government agency and corporate obligations (excluding mortgage-backed securities):		
Issued by U.S. government agencies	65,271	65,271
Issued by U.S. government sponsored agencies	1,551,097	1,551,097
Securities issued by states, territories and possessions and political subdivisions in the U.S.:		
States, territories and possessions general obligations	237,113	237,113
Political subdivisions of U.S. States, territories and possessions general obligations	40,360	40,360
Revenue and assessment obligations	90,088	90,088
Mortgage-backed securities (includes residential and commercial MBS):		
Pass-through securities:		
Guaranteed by GNMA	550,732	550,732
Issued by FNMA and FHLMC	1,407,432	1,407,432
CMOs and REMICs:		
Issued by FNMA, FHLMC or GNMA	663,720	663,720
Other debt and other fixed income securities (excluding short-term):		
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	3,419,653	3,419,301
Unaffiliated foreign securities	34,973	34,973
Money Market funds	837,716	837,716
Real estate investments	176,352	176,352
Cash and cash collateral for investments	1,110,379	1,110,379
Total assets	$11,006,221	$11,005,869